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C O N F I D E N T I A L SECTION 01 OF 02 NICOSIA 000675

SIPDIS

TREASURY FOR ATUKORALA

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TAGS: [ECON](#) [PREL](#) [PGOV](#) [CY](#)
SUBJECT: ON EVE OF NEGOTIATIONS, TURKISH-CYPRIOT ECONOMY
WEAK

REF: A. NICOSIA 621
[1](#)B. NICOSIA 146

Classified By: CDA J. COHEN FOR REASONS 1.4 (B) AND (D)

[1](#)1. (C) Summary. The economy of north Cyprus continues its year-long decline exacerbated by the "government's" lack of cash in the wake of higher than anticipated expenses. "Government" creditors are not being paid on time and the ripple effects are felt throughout the economy and the banking system. The "government's" inability to control its expenses means that it must rely on raising fees and seeking additional handouts from Turkey to make its monthly payroll. Most T/Cs now consider Talat's ruling CTP party as having demonstrated poor economic stewardship and governance. We don't believe this will affect Talat's ability to negotiate a reunification agreement, but CTP's inability to marshal its political resources to properly deal with economic and budget problems could influence how T/Cs view any agreement Talat reaches with the G/Cs, and how they vote on any resulting referendum. End Summary.

Economy Bad, Getting Worse

[1](#)2. (SBU) While no statistics for 2008 will be available until 2009, indications are that north Cyprus' economy is declining faster than it did last year when it realized a negative 2.5 percent change in GDP. Conversations with building contractors, bankers, and tourist sector operators all indicate a significant slowdown in economic activity and low levels of business confidence. Overinvestment in residential construction, combined with declining demand for second or retirement homes from the key British market, has led to many construction sites with unfinished buildings and vacant houses. Tourism from northern Europe has declined even as new hotels have opened in the north over the past several years. While tourism from Turkey has increased and, in raw numbers, more than made up for the decrease in tourists from northern Europe, Turkish tourists stay for less time and spend far less money locally. The result is high hotel vacancy rates (28 percent in June) and less spending in tourist-oriented establishments.

The Cash Runs Out

[1](#)3. (C) Most critically, the "government" is suffering a severe budget crunch. The "Undersecretary of Finance" told us that, while tax revenues are broadly in line with projections, the cost of government is far more than anticipated due to inflation running at around 20 percent annually vs. budget projections of 5 percent. With a bi-monthly cost-of-living-adjustment (COLA) for all "government" workers and retirees, increased subsidies for farmers because of the on-going drought, transfers to the

"government-owned" airline to keep it operational, and subsidies that lowered the price of fuel and electricity, the "government" has simply run out of cash. The "Undersecretary" explained that every month, after "finding funds to pay civil servant salaries and pensions," he must decide which suppliers will or will not be paid. The failure of the "government" to pay its debts to the private sector is resulting in a severe cash shortage in the overall economy. In this environment, banks have restricted lending to only their best, most well-capitalized customers, and are seeing a significant increase in non-performing loans from both companies and consumers. One banker told us that non-performing loans increased from 2.5 to 7 percent of his loan portfolio so far this year.

14. (SBU) In a bid to bring the budget under some control, "Prime Minister" Soyer tried to change the COLA (to a quarterly adjustment from the current bi-monthly) and end the current "government" practice of paying a 13th monthly salary at year-end to civil servants and pensioners. The response of unions, even those aligned with the ruling CTP party, was to strike. The union answer to Soyer's pleas that there was simply not enough money was "ask Turkey for more." Not receiving any support from his party or "President" Talat, Soyer was forced to retreat from fiscal discipline and undertake the current policy of raising "government" fees.

Finding Money

15. (SBU) The enormous public sector provides a floor under the overall economy. Public sector workers, including those

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at state-owned enterprises, comprise 31.5 percent of the north's workforce of 90,000. Another 27,000 persons receive "government" pensions, and 24,000 payouts from the "government-run" retirement provident fund. Thus, the 61,500 private sector workers effectively support 79,000 civil servants and retirees. This is made possible due to Turkey's continuing contribution to the budget, US\$450 million this year of the north's total budget of US\$2 billion. Requests for additional funds by Soyer to Turkish Prime Minister Erdogan during the latter's July visit to Cyprus resulted in agreement to transfer approximately US\$30 million from the infrastructure budget, funded largely by Turkey, to the north's current budget. This has provided sufficient funds for slightly more than one additional month of salaries and transfer payments.

16. (SBU) To raise additional funds, the "government" has over the past six weeks significantly increased prices for fuel and electricity. According to the acting head of the planning bureau (responsible for compiling "government" statistics and helping create the "government" budget) the increases (more than 50 percent this year) are in excess of the actual increase in the price of oil even considering the end of the previous price subsidy. Large increases in the charges for car registration and annual road tax were also implemented, and "TRNC citizens" traveling via Turkey to third countries are now required to travel on a "TRNC" passport (cost US\$150) rather than travel on their ROC-issued passports. Our "government" contacts could not estimate how much additional revenue these changes will bring in, noting widespread tax evasion. T/C businesspeople complain that, due to their isolation, their cost basis is already higher than that of G/Cs (see reftels), and these increased charges will make them less competitive still.

17. (C) Comment: A private T/C economist told us that with the lira having returned to its beginning 2008 level against the US\$ (about \$1.17/1YTL -- after having depreciated by as much as 13 percent during the second quarter) and with the global price of commodities in a recent declining trend, the "government" should be able to continue paying salaries, pensions, and some creditors through the rest of the year

without additional funds from Turkey. However, the shrinking economy and rapid policy U-turns have severely damaged the economic and governance credentials of Talat's CTP party. Most T/Cs are not focused on the upcoming bi-communal negotiations, so Talat's negotiating flexibility is unlikely to be immediately affected by these factors. However, if trust in the ruling CTP party is so severely damaged by perceived economic mismanagement that it colors voters' perceptions of Talat's capabilities and judgment in general, it could be a factor in a future referendum on Cyprus' reunification.

Cohen